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How to Buy Real Estate in Germany

For most of the last decade Germany has seen a strong influx of foreign capital into its real estate market. While the first foreign investors that became part of this trend came from northern and western European countries, the United States and Israel, capital is now coming in from southern European countries and in some cases from the Arab world. Investors from other parts of Asia have not played a great role in this trend yet.

This article provides a guide through the reasons for which real estate in Germany can be of interest for investors from Taiwan and it explains by way of a practical example, the legal procedure of the acquisition of a property in Germany.

Why Invest in German Real Estate?

Compared to Asian countries the development of the general real estate is rather stable. One cannot expect great increases in the values of properties but one also does not have to fear sharp decreases. Yet a well-managed property can produce stable yields. An investment in Germany is therefore interesting as a kind of savings box for investors from volatile markets. This is in particular the case with regard to residential real estate. Under certain circumstances, real estate investment in Germany can also grant the investor right of residence in Germany.

The Schöneberg Example: Commercial Facts

There are, as in any legal system and market, many varieties of how to structure a real estate transaction. As this article cannot replace a scholarly book, it seems to be the best approach to discuss

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the example of a typical reasonably simple asset deal that has recently been carried out. It needs to be known too, that the article contains a number of simplifications and only shows the rough structure of the transaction of course.

The Property

a) Building and Rent

In this case the purchaser was interested in a nice residential multi-family building, erected around 1900 with a nice neo-baroque facade located in the central district of Schöneberg in the City of Berlin. The district of Schöneberg is a lower middle class area. It is worth noting that it is not untypical for investors in Germany to buy houses that are over a hundred years old. These houses have typically been continuously maintained and renovated over the decades so they are far from the end of their life circle after a hundred years. Within its five stories the building had 30 apartments and two commercial units. Approximately 1,900 sqm (square meters) were used for residential purposes and approximately 200 sqm for commercial purposes. The monthly rental income was around 10,000 Euros, 8,800 of that came from the apartments and 1,200 Euros per month were paid by the commercial tenants.

b) Operating Expenses

The rental income as mentioned above excludes the advance payments for operating and heating expenses. Typically these expenses are borne by the tenant. This means that the tenants pay advances for these costs to their landlord in monthly installments as a supplement to the actual rent. Once a year the landlord must account for these monies vis-à-vis the tenants. He must declare how much he spent for the operating expenses and the heating, and distribute them to the tenants in a reasonable fashion. This article cannot explain the details of this but it is important to know that a lot of the costs that go along with operating a property and all of the costs that go along with heating the property are not part of the rent that

are paid by the tenants separately. Also typically it is not the matter of the landlord to provide electricity, cable TV or telecommunications to the tenant. Costs for maintenance and repairs as well as refurbishing costs and administrative costs are not part of the operating expenses that are typically paid by the tenants. As already mentioned, the figures mentioned above and the other figures pertaining to the rent concern the “net rent”, i. e. the rent excluding operating costs and heating costs.

c) Purchase Price and Yield

The net rent per sqm over the entire building was 4.54 EUR which was significantly below the rent that the market permits in case of the conclusion of a new lease (e.g. in case of vacant apartments). Thus, evidently the investor hoped to raise the value of the property by using the potential increase of the total rents of the building. The price per sqm was 845 EUR which is also low but reflected a certain need for renovation and modernization of the building. The purchase price was 1.860.000 EUR. This means that the initial gross yield (based on the net rent) was 6.45 % or inversely expressed the purchase price was a 15.4 multiple of the annual net rent.

The Schöneberg Example: the procedure

Letter of Intent

In a first step of the acquisition process the vendor and the purchaser agreed in principle to a Letter of Intent (LOI) that they want to conclude a Sale and Purchase Agreement (SPA) concerning the Schöneberg property. Key data of the envisioned SPA are put down in the LOI, in particular of course the price and the key facts of the property.

In the LOI the vendor granted four weeks of exclusivity, i. e. he promises not to negotiate with other potential purchasers and not to sell the property to anyone else. These agreements have no binding character except in very rare circumstances. This means that the

purchaser does not have a recourse in view of his due diligence costs, if the vendor decides to sell the property to another party or at a higher price, even if he does so during the exclusivity period.

Yet LOI's are useful means of proof what the parties presumptions were (especially the rent and the duration of the commercial lease agreements) and what has been economically agreed. This is useful when it comes to negotiating the exact terms of the SPA, in particular in case the due diligence shows that the property is not quite as good as presumed.

Due Diligence

After the LOI was signed the purchaser instructed his professional advisers to examine the property from a technical, environmental, valuation and legal perspective. Just like in Taiwan the most important legal questions are the following:

Title: Can the vendor deliver the ownership of a property?

Encumbrances: What are the encumbrances that exist for this property?

Leases: Are the tenants' obligations what they look like in the LOI?

Public Law: Are the building and the usages agreed in the lease agreements in accordance with the public law, in particular the building permits?

We would like to briefly discuss these questions.

Title: Can the vendor deliver the ownership of a property?

In the German legal system this is an easy question to answer. To do so it is only necessary to request excerpts from the competent land register ("*Grundbuchamt*"), a section of the court system. If the excerpts show the vendor as the registered owner, the vendor can deliver the property. There is no need to conduct searches or to give any newspaper notices the way it is done in many other jurisdictions. As the records in the land register pertaining to title are

rigidly followed, the person registered as the owner will in all likelihood also be the owner. But even if he were not, this would not matter too much. The German Civil Code provides for a presumption that the registered owner is indeed the owner. If somebody buys the property from him, he can become the owner even in the very rare case that the land register was wrong. The exception to this rule is that the purchaser cannot become the owner if he is not buying in good faith.

In our case the vendor was registered as the owner and the purchaser had no reason to believe that the land register was wrong. Therefore, further title investigations were not necessary.

In turn quite a number of rigid formalities and quite complicated mechanisms unknown to the Taiwanese investor are necessary in a German SPA, which eventually enable the competent registrar at the land register who has to verify the validity of the transaction to register the transfer of ownership.

Encumbrances: What are the encumbrances that exist for this property?

An excerpt from the land register will also tell the reader much about the property's encumbrances. Just like with the transfer of ownership any changes of the encumbrances are only affected once the registrar has registered them. For this reason, the purchaser can usually rely on the register being accurate and complete. The purchaser of the Schöneberg property was of course interested in knowing, if there were rights of ways for other property owners or rights to maintain pipes that are secured by a registration in the land register. If they do not impair the usage of the property, they will often remain registered in the course of the transaction. In our case the property was only encumbered with a land charge in favor of the bank that has financed the acquisition of the property by the current vendor. As the purchaser in this case did not want to assume a land charge of the vendor's bank, the SPA needed to ensure that the land charge was deleted.

Leases: Are the tenants' obligations what they look like in the LOI?

Upon the transfer of ownership of the property the purchaser becomes the new landlord of the tenants. Therefore the purchaser is of course interested in knowing what the residential contracts say. In particular he will verify if rents agreed in the lease agreements are as high as mentioned in the LOI. While it is the job of the purchaser to assess if the tenants have a credit rating to his liking, it is the job of the lawyer to assess if the lease agreements are valid and if they give the landlord the claims that the vendor promised during the negotiation. This part of the due diligence is more important and trickier in view of commercial leases. The reason is that residential leases can practically only be cancelled by the landlord in case the tenant does not pay the rent. Also it is typically not possible to conclude residential lease agreements that have a certain minimum duration. In contrast, typically the tenant can always cancel the lease agreement with three month's notice.

Commercial lease agreements on the other hand can be concluded for long terms and it is often very important for the landlord to know how long the lease agreement will run. For a number of particularities in the German Commercial lease law this can sometimes be a tricky question. In this case the focus of the due diligence was on the legal possibilities to uplift the rent. As mentioned before, the landlord cannot just cancel the lease except in the case of nonperformance by the tenant. This means that in principle the rent stays put where it is. Residential rents are not connected to a consumer price index. Yet as mentioned above – the actual rents were below the rents that were achievable in case of the conclusion of the new lease agreement. In a market situation like this it is possible to adapt the rent during the life of the lease up to a certain level. It goes beyond the scope of an article like this to explain how this works. Another reason to lift up the rent during the life of the lease is to modernize the property. A modernization is for example the installation of a lift or the replacement of an old central heating

by a more modern and energy efficient heating system. 11 % of the modernization costs (but not the costs for maintenance and repair) can be attributed to the tenants per annum. Another way of raising the rent is to buy off tenants. In a market situation as it is currently in Berlin landlords often promise severance payments to tenants in exchange for a termination of the lease. Once the apartment is vacant the landlord can – if he wishes to – modernize the apartment and rent it out to a new tenant. Unless very untypical circumstances apply, there is no legal limit as to the amount of such a newly agreed rent.

Public Law: Are the building and the usages agreed in the lease agreements in accordance with the public law, in particular the building permits?

As in most countries a building in Germany needs to be erected in line with the applicable public zoning and safety rules. For many buildings it is necessary to apply for a building permit. For a building that is over a hundred years old it can be presumed that its structure was erected in accordance with applicable public zoning and safety rules. But sometimes it can be doubtful if the usage of the spaces is in line with the law. This pertains in particular to apartments that were built into attics. It happened often that these were built without the necessary permissions. Also, in some circumstances it may be illegal to convert an apartment into an office and vice versa.

The net of the public law is even more closely knit in view of commercial leases.

In our case the usages of the commercial spaces were in line with the public law.

Other Legal Questions

A typical other risk which should be assessed from a legal point of view would be ongoing or threatening legal disputes or upcoming property fees like road building contributions. It is advisable to ask

the competent local authority about the latter. There is no public register concerning legal disputes that relate to a property. In order to find out about them one needs to ask the vendor and have him assure in the Sale and Purchase Agreement (SPA) that there are none to his knowledge or have him disclose his knowledge. It may be advisable to include appropriate indemnities in this regard into the SPA.

The Sales and Purchase Agreement

As the property was still acceptable to the purchaser after the legal due diligence and the technical and tax professionals had given their green light too, the purchaser instructed a notary to draft a SPA with the input of his lawyer. Living up to its reputation Germany's laws require a number of formalities in a property SPA. The most important fact is that the SPA is invalid if it is not recorded by a notary acts as neutral officer between the parties. He is qualified as a lawyer but typically needs to have a number of years of experience and particularly good legal exams plus a certain number of qualifying courses. He does not only have the function to certify the authenticity of the signatories' signatures but he has also to actually read aloud the whole contract in a procedure that can sometimes last several hours. While the obligation of reading the text aloud might have its roots in old Germanic legal conceptions, it always happens that last corrections to the SPA are made in this last formal step before the actual signature. The contract that has been read aloud and gone through this last filter is recorded in the SPA deed. The notary also informs the parties about the legal risks that go along with particular stipulations in the SPA. Therefore, a considerable part of the session time is spent on information and explanation in particular for newcomers. Due to the involvement of a notary many German purchasers do not consult a lawyer but rely on the notary only. Obviously this saves costs. Yet, this should only be done by experienced market participants. Not surprisingly lawyers do not encourage purchasers to do so. There are laws about notaries' and lawyers' fees. The notary's fees are fixed

by these laws the notary is particularly forbidden to take fees lower than stipulated in the law. The fees depend mostly on the value of the contract that the notary is involved with. The higher the purchase price the higher becomes the fee. Lawyers are more flexible and can negotiate their prices relatively free. They may however not accept contingency fees.

The Notary's Responsibilities

The notary has the function to ensure that the SPA with its quite complicated mechanisms is executable; in particular that the land registrar will be obliged to register what was agreed in the SPA. Sometimes this is not an easy task as the records and formalities are quite rigid. For this reason foreign based investors and their banks often request a proof of the notary's professional indemnity insurance before instructing them.

Due to his responsibility the notary often drafts the SPA while the key information is given by the parties of course. The notary has to ensure that the SPA will include all information in the form that will be required by the competent registrar of the land register for the registration of four matters that are typically registered in the acquisition process:

- The priority notice,
- the deletion of the land charge of the vendor's bank,
- the registration of the land charge of the purchaser's bank,
- the registration of the change of ownership.

These steps structure the legal acquisition process. The registrar will only complete any of these registrations, if he is provided with documents issued by government authorities or notaries that instruct him to do so. The first thing the notary needs to look after is that the parties of the SPA have been duly represented during the notary's recording and that all documents documenting this have been issued by government or a notary. Ensuring this may require

quite a bit of paper work. Excerpts from foreign commercial registers need to be certified by an *Apostille* and translated into German by a sworn translator for example.

The SPA will contain the acting parties, how they are represented, and how this is documented first. Much like in any other countries the SPA concluded in this country then continues with a definition and a description of the bought property, the agreed purchase price and other practical and necessary stipulations concerning the transfer of collaterals, the duties to account for collected advance payments, for operating expenses etc. Yet, this article will focus on the mechanisms in the land register that are necessary to reach the ultimate goal of the transaction, the safe exchange of the purchase price and the ownership of the property. In view of this it is important to understand that the ownership of a property only transfers once the purchaser is registered in the land register as the new owner.

The Registration of the Priority Notice

In our Schöneberg example the parties agreed as they would in almost any SPA that a priority notice (“*Vormerkung*”) was to be registered. The person to apply for this registration was the notary. He has to do so right after the conclusion of the SPA. This was part of his duty to supervise the execution of the agreement. The registered priority notice secures the claim of the purchaser of the transfer of ownership, which derives from the SPA. Simplifying it: With this registration in his hands the purchaser knows that he will eventually become the registered owner after he has paid the purchase price. Yet, the priority notice does not entitle the purchaser to sell on the property as would be the case if he had been registered as the owner straight away. This is how the priority notice also serves the security interest of the vendor. He does not have to fear the loss of the property without having received the purchase price. For this reason almost every SPA will provide that the vendor give his con-

sent for the registration of a priority notice in the land register before the purchase price is paid.

The Deletion of the Vendor's Bank's Land Charge

The Schöneberg property was encumbered with a land charge in favor of the bank which had financed the vendor. A land charge gives the beneficiary – typically a bank – the right to enforce a claim against a borrower in case of default and to execute that claim by taking over the management of the property and keep the profits or by selling it in an auction. The purchaser of the Schöneberg property needed to be sure that this encumbrance was deleted before he paid the purchase price – not only in his own interest but also because his bank needed to be sure that its loan was secured by a first ranking land charge. The difficulty is though that the purchaser's bank will only give the consent for the deletion of the land charge when its loan is repaid or if it is secured that it will be repaid. Typically, much of this repayment will have to come from the purchase price, as was the case here. This Catch-22 problem is typically solved with the help of a notary.

The SPA made it a prerequisite of the maturity of the purchase price that the notary confirm to the purchaser that the deletion of the land charge of the vendor's bank is secured. To this end the vendor requested his bank to give a deed to the notary containing the consent of the bank to delete the land charge. As the result of the vendor's negotiations with his bank, the bank produced the deed with the necessary consent. However, the bank instructed a notary to make use of the consent only in case he had proof that a certain sum of the purchase price had been paid to an account of the bank. In accepting this instruction the notary also took over a fiduciary responsibility vis-à-vis the vendor's bank. Sometimes banks want the purchaser to pay the purchase price to an escrow

account of the notary before they allow the notary to make use of the bank's consent for the deletion of the land charge. A payment to one of the lawyers will not give the bank enough security as the lawyer has a partial role and must not accept a neutral position between his client and the other party. Once the notary is in the possession of the necessary deed he confirms to the purchaser that the deletion of the land charge was secured, provided that the purchaser paid a part of the purchase price to the vendor's bank account. Thus, the purchaser could be sure that the land charge was going to be deleted once the purchase price had been paid.

The Maturity Notice – the Change of “Economic Ownership”

The registration of the priority notice and the secured possibility to delete the vendor's bank's land charge are typically the most important prerequisites for the maturity of the purchase price. The first secures the claim of the purchaser for the transfer of ownership and the second ensures that the financing bank's loan is collateralized by the property. It is the matter of the notary to verify whether both prerequisites have been fulfilled. Once this is the case (and possible other prerequisites as defined in the SPA fulfilled, too), the notary issues a maturity notice to the purchaser. In the Schöneberg property example the maturity notice stated that according to the SPA the purchaser had four weeks after receipt of the notice to pay the purchase price (grace period). Again the notary acts as an executive neutral body between the parties avoiding disputes on who has to do what in what stage of the acquisition process. He ensures that the purchaser does not have to pay before all prerequisites agreed in the SPA have been fulfilled, and yet, even if the purchaser would like to have some more time for negotiations with his financiers, the price is typically due two weeks after these prerequisites are fulfilled. The Schöneberg property SPA further provided that the possession of the property change to the purchaser on the day after the payment of the purchase price (while the transfer of ownership was yet to be effected by the registration of that transfer in the land register). Also the SPA provided that from this date the

vendor assigned all benefits (in particular the rents and insurance claims) to the purchaser and that the purchaser indemnified the vendor from all burdens that go along with owning the property. One can therefore say that the “economic ownership” change on the day of the payment of the purchase price.

The Registration of the Land Charge in Favor of the Purchaser’s Bank

Like almost all banks, the bank financing the acquisition of the Schöneberg property wanted to secure its loan with the land charge. This new land charge needed to be registered (all the registration had at least to be ensured) before the bank would contribute its share to the purchase price. The purchaser’s bank made it a condition precedent in the loan agreement that it was secured that a first ranking land charge in its favor was registered in the land register. For this reason the SPA contained a power of attorney from the vendor to the Purchaser to encumber the property with the land charge in the purchaser’s bank’s favor. All other obligations that had to do with the relationship between the purchaser and his bank were stipulated in the loan agreement between these parties and had nothing to do with the vendor. In particular it was not a prerequisite for the maturity of the purchase price that the purchaser’s bank was registered as a land charger. Thus, the purchase price could have become due regardless of this registration. The risk to get the purchaser’s bank to finance the transaction vested with the purchaser. This is (of course) the typical way to distribute the risk. In order to register a land charge in favor of a financier the notary has to record (read aloud etc.) a land charge deed. Also in this case he has a responsibility for the feasibility of the obligations set forth in the deed. In our example the land charge was recorded a few days after the conclusion of the SPA. The notary turned the deed in at the land register without further consent of the purchaser or his bank, and the land charge in favor of the purchaser’s bank was registered a few days later. The newly registered land charge ranked below the one that was already registered in the land register, so it did not

diminish the legal position of the vendor's bank. As pointed out above, it was ensured that the payment of the purchase price led to the deletion of the higher ranking land charge in the vendor's bank's favor. As a result, the land charge in favor of the purchaser's bank had no higher ranking land charge above it, and was therefore ranking first. The purchaser was of course eager to have the land charge registered before the notary issued the maturity notice. Ideally the priority notice and the new land charge are registered on the same day. At the latest the land charge should be registered during the grace period after the delivery of the maturity notice (in this case four weeks). As things went alright and the land register's deed was okay, the purchase price of the Schöneberg property could be paid in time.

The Registration of Ownership

As pointed out above, the ownership is transferred to the purchaser once the registrar of the land register registers this transfer of ownership. To achieve this all the SPA in the Schöneberg property example provided then that the notary was obliged to apply for the registration of the transfer of the ownership after he has been given proof of the payment of the purchase price. As mentioned above, the registration will take a few weeks which is bearable as the purchaser is already in possession of the property and allowed to collect the rents by virtue of the vendor's assignment of the rents.

Tax Implications

a) Real Estate Transfer Tax

The purchase of real estate in Germany triggers Real Estate Transfer Tax (RETT). The exact level of this tax is determined by the location of the property within one of Germany's 16 states. The levels set by the individual states range from 3.5 % to 5.5 % of the purchase price. For our example of the property located in the state of Berlin, RETT would be 5 %. The proof of payment of RETT is condition for the transfer of title by the land register.

Under certain preconditions which involve the sale of shares in a company holding the property, rather than the property itself, RETT may not be triggered. Whether this is a feasible way of purchase should be determined in each case together with German advisors.

b) VAT

Generally, no VAT is levered on real estate transactions in Germany. However, it is optional for the Vendor and Purchaser to agree on paying VAT which might have a positive tax effect in case both parties are commercial enterprises.

c) Income tax

Rental income in Germany may be subject to German income taxation even if the investor is a foreign national or entity. Details should be determined prior to the actual purchase in consultation with respective experts.

Summary

The Taiwanese-German commercial relations are tightening and may soon lead to closer relations in the respective real estate markets. While East Asia offers a very dynamic yet volatile environment for real estate investments, Germany's market can be considered to be a safe haven shaped by relatively stable prices and a stable legal and economic environment. The German market has become accustomed to foreign investors from many destinations and will be able to do so for Taiwanese investors, too. Yet, bridging the gap between the Taiwanese and the German market will need great care. The Taiwanese buyer would be well advised to put his Taiwanese legal/financial advisors in touch with his German advisors to ascertain that there is synchronization of the diverse aspects of Taiwanese law with those of the applicable German legislations and to ensure that a suitable tax efficient purchasing structure is utilized.

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